

Letter of Findings Number: 06-0351
Income Tax
For the Tax Years 2004

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ISSUES

I. Adjusted Gross Income Tax – Imposition.

Authority: IC § 6-8.1-5-1(b); IC § 6-3-2-1(a); 26 U.S.C. 4 § 114(a)(b); [45 IAC 3.1-1-2\(1\)](#); Income Tax Information Bulletin 28 (September 2001); *Indiana Department of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248 (Ind. 2003).

The Taxpayer protests the imposition of adjusted gross income tax on proceeds from the exercise of certain stock options.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2\(b\)\(c\)](#).

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

During his working career, the Taxpayer was employed in Indiana. As part of his compensation package, the Taxpayer received certain stock options that were not part of a qualified retirement plan. After the Taxpayer retired to Florida in 2004, he exercised some of these stock options. The Indiana Department of Revenue (Department) assessed additional adjusted gross income tax, penalty, and interest on the Taxpayer's income from the exercise of these stock options for the tax period 2004. The Taxpayer protested and a telephone hearing was held. This Letter of Findings results.

ISSUES

I. Adjusted Gross Income Tax – Imposition.

DISCUSSION

The Department assessed adjusted gross income tax on the proceeds from the exercise of stock options. The Taxpayer protested the assessment. The Taxpayer argued that as a Florida resident at the time of the exercise of the stock options, the resulting income was subject to income taxation in Florida rather than Indiana.

Indiana imposes an adjusted gross income tax "on that part of the adjusted gross income derived from sources within Indiana of every nonresident person." IC § 6-3-2-1(a). Indiana source income is defined at [45 IAC 3.1-1-2\(1\)](#) as "compensation for services, including fees, commissions and similar items." Indiana source income would be income derived from services performed in Indiana. The Taxpayer's former employer gave the Taxpayer the stock options as compensation for the Taxpayer's work for the company in Indiana. Under the Indiana law, therefore, the stock options would be considered income derived from Indiana employment or Indiana source income subject to Indiana income taxation.

There is, however, a federal statute which deals with the power of individual states to impose income taxes on their residents and former residents. 26 U.S.C. 4 § 114(a) exempts certain income from taxation as follows:

No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).

"Retirement Income" for purposes of this statute is defined at 26 U.S.C. 4 § 114(b) as income from retirement plans qualified under a variety of provisions of the Internal Revenue Code of 1986.

Federal law supercedes state law. Indiana must exempt Indiana source income pursuant to these statutes, Indiana is precluded from imposing its adjusted gross income tax on qualified retirement income of former residents who have moved to another state.

Income Tax Information Bulletin 28 (September 2001) addresses the taxability of Indiana source income to non residents and the application of the federal exemption as follows:

Income received from Indiana sources is considered Indiana income to nonresidents, except certain types of Indiana source income that are subject to tax only by the taxpayer's state of legal residence. Interest, dividends, royalties and gains from the sale of capital assets are subject to tax only by the taxpayer's state of legal residence unless such income results from the conduct of a trade or business. If a trade or business is conducted in Indiana, the income from such should be reported as Indiana income.

Income from a *qualified* pension, annuity, profit sharing or *stock option plan* is subject to tax by the taxpayer's state of legal residence. Lump sum distributions from qualified plans are subject to tax by the state that, at the time of distribution, is the taxpayer's state of legal residence.

Deferred compensation *other than from a qualified* retirement plan, accumulated vacation, bonus, severance and sick pay are directly attributable to services performed, and is taxable by the state where the services

were performed. (*emphasis added.*)

All tax assessments are presumed to be valid. IC § 6-8.1-5-1(b). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.* Exemption statutes are to be strictly construed against the Taxpayer. *Indiana Department of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248 (Ind. 2003).

The Taxpayer received stock options as compensation for his services performed in Indiana. The income from the exercise of the stock options, therefore, was Indiana source income. Therefore, it is subject to the Indiana adjusted gross income tax unless an exemption applied. The Taxpayer was unable to sustain his burden of proving that the stock options were exempt from Indiana income taxation because they qualified as a retirement program under any section of the Internal Revenue Code of 1986. Therefore, the federal exemption prohibiting Indiana from imposing adjusted gross income tax on income derived from the Taxpayer's exercise of the stock options in a qualified retirement plan did not apply in this case. The Department properly imposed the tax.

FINDING

The Taxpayer's protest is respectfully denied.

II. Tax Administration - Ten Percent Negligence Penalty.

DISCUSSION

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation [45 IAC 15-11-2](#)(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at [45 IAC 15-11-2](#)(c) as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that his failure to pay the assessed adjusted gross income tax was due to reasonable cause rather than negligence.

FINDING

The Taxpayer's protest to the imposition of the penalty is sustained.

Posted: 10/03/2007 by Legislative Services Agency
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